

# Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Refer Reply To:

CC:ITA:7

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Date:

September 24, 2008

Re: Request for rulings under sections 167 and 168

Taxpayer =

S1 =

S2 =

S3 =

A =

City =

StateX =

N1 =

N2 =

N3 =

Remainderman =

N4 =

N5 =

N6 =

Dear :

This letter responds to a letter dated April 3, 2008 submitted by Taxpayer requesting rulings under sections 167 and 168 of the Internal Revenue Code regarding the purchase of a term interest in certain property by Taxpayer.

## FACTS

Taxpayer represents that the facts are as follows:

S1, S2, and S3 (collectively, the "Sellers") own A and the land underlying A, which are located in City, StateX (collectively, the "Property"). A consists of N1

buildings as well as a parking structure and a surface parking lot. S1 owns N2 of the buildings, all of which contain residential rental apartments. S2 owns N3 of the buildings, all of which contain residential rental apartments and commercial retail space, and also owns the parking structure. S3 owns the surface parking lot.

S1, S2, and S3 each owns its interest in the Property through a StateX land trust. Further, S1, S2, and S3 each represents that it is properly treated as the owner of the Property for Federal income tax purposes.

S1, S2, and S3 each have entered into an Agreement of Purchase and Sale (Remainder Interest) (the "Remainder Interest Purchase Agreements") with Remainderman and an Agreement of Purchase and Sale (Estate for Years) (the "Lead Interest Purchase Agreements") with Taxpayer.

The Remainder Interest Purchase Agreements provide for the purchase of a remainder interest in the Property (the "Remainder Interest") by Remainderman for a total of \$N4. Remainderman's purchase of the Remainder Interest will neither directly nor indirectly be funded by Sellers or Taxpayer. Remainderman intends to hold the Remainder Interest as a long-term investment. Pursuant to the Remainder Interest Purchase Agreements, Remainderman will have the unrestricted right to sell, assign, encumber, or otherwise dispose of, all its rights in the Remainder Interest.

Upon the closing of the Remainder Interest Purchase Agreements, Sellers will convey the Remainder Interest to Remainderman and will retain an estate for years in the Property for N5 years.

The Lead Interest Purchase Agreements provide for the purchase of Sellers' N5-year estate for years in the Property (as well as in any fixtures, equipment, and personalty owned by Sellers that are located on the Property and used in conjunction with the Property, and in the leases for the residential and commercial spaces of the Property) (the "Lead Interest") by Taxpayer for a total of \$N6 immediately after the sale of the Remainder Interest by Sellers to Remainderman. Taxpayer's purchase of the Lead Interest will neither directly nor indirectly be funded by Sellers or Remainderman. Taxpayer intends to use the Lead Interest in its active business of renting commercial and residential property.

Pursuant to the Lead Interest Purchase Agreements, all of the benefits and burdens of ownership in the Property during the term of the Lead Interest will be transferred to Taxpayer. Taxpayer will have the unrestricted right to sell, assign, encumber, or otherwise dispose of, all of its rights in the Lead Interest. Further, Taxpayer will pay all of the carrying costs associated with the Lead Interest.

Each direct and indirect owner of Sellers is unrelated (within the meaning of section 267 of the Internal Revenue Code) to each direct and indirect owner of both

Taxpayer and Remainderman. Each direct and indirect owner of Taxpayer is unrelated (within the meaning of section 267) to each direct and indirect owner of Remainderman. RULINGS REQUESTED

1. If the Lead Interest is used in a trade or business or held for the production of income by Taxpayer, Taxpayer is entitled to depreciate the portion of Taxpayer's basis in the Lead Interest allocable to the land ratably over the term of the Lead Interest under section 167(a). However, no depreciation deduction is allowable under section 167 or any other provision of the Code to Taxpayer for the Lead Interest for any period during which the Remainder Interest is held (directly or indirectly) by a related person (within the meaning of section 267(b) or (e)).
2. If the Lead Interest is used in a trade or business or held for the production of income by Taxpayer, Taxpayer is entitled to depreciate the portion of Taxpayer's basis in the Lead Interest allocable to the buildings (including the parking structure) and the surface parking lot in accordance with section 168. However, no depreciation deduction is allowable under section 167, section 168, or any other provision of the Code to Taxpayer for the Lead Interest for any period during which the Remainder Interest is held (directly or indirectly) by a related person (within the meaning of section 267(b) or (e)).

#### LAW AND ANALYSIS

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business or held for the production of income.

Section 167(d) provides that, in the case of property held by one person for life with remainder to another person, the depreciation deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. See also section 1.167(h)-1(a) of the Income Tax Regulations.

Section 167(e)(1) provides that no depreciation deduction shall be allowed under section 167 (and no depreciation or amortization deduction shall be allowed under any other provisions of the Code) to the taxpayer for any term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person.

Section 167(e)(4)(B) provides that if, but for section 167(e), a depreciation or amortization deduction would be allowable to any person with respect to any term interest in property, the principles of section 167(d) shall apply to such person with respect to such term interest.

Section 167(e)(5)(A) provides that, for purposes of section 167(e), the term “term interest in property” has the meaning given such term by section 1001(e)(2). Section 1001(e)(2) provides that the term “term interest in property” means a life interest in property, an interest in property for a term of years, or an income interest in a trust.

Section 167(e)(5)(B) provides that, for purposes of section 167(e), the term “related person” means any person bearing a relationship to the taxpayer described in section 267(b) or (e).

Section 1.167(a)-1(a) provides that the allowance for depreciation is the amount that should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property.

Section 1.167(a)-1(b) provides that, for purposes of section 167, the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in the taxpayer’s trade or business or in the production of his income.

Section 1.167(a)-3(a) provides that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance.

Section 1.167(a)-5 provides that when depreciable and nondepreciable property are acquired together for a lump sum, the acquisition cost must be allocated between the depreciable property and nondepreciable property on the basis of the respective values of the depreciable property and the nondepreciable property.

Generally, a taxpayer who purchases a term interest is entitled to deduct the cost of that interest over its expected life. Gordon v. Commissioner, 85 T.C. 309, 322-323 (1985); Lomas Santa Fe, Inc. v. Commissioner, 74 T.C. 662, 683 (1980), affd. 693 F.2d 71 (9<sup>th</sup> Cir. 1982). This principle applies even though the property underlying the term interest is not depreciable. Lomas Santa Fe, Inc., 693 F.2d at 72-73 n.2; Gordon, supra at 323. However, if a taxpayer, without additional investment, splits its interest in nondepreciable property into a term interest and a remainder interest and the taxpayer retains the term interest, depreciation deductions are not allowable under section 167(a) for that term interest. Lomas Santa Fe, Inc. Further, pursuant to section 167(e)(1) and (e)(5)(B), depreciation deductions are not allowable under the Code for any term interest in property for any period during which the remainder interest in that property is held (directly or indirectly) by a related person within the meaning of section 267(b) or (e).

Taxpayer has represented that each direct and indirect owner of Sellers is unrelated (within the meaning of section 267) to each direct and indirect owner of both Taxpayer and Remainderman, and that each direct and indirect owner of Taxpayer is unrelated (within the meaning of section 267) to each direct and indirect owner of Remainderman. Taxpayer also has represented that Taxpayer's purchase of the Lead Interest will neither directly nor indirectly be funded by Sellers or Remainderman. Further, Taxpayer has represented that it intends to use the Lead Interest in its active business of renting commercial and residential property. These representations are material facts. Accordingly, the only issue for our consideration is how Taxpayer may depreciate its Lead Interest under section 167(a).

While the Lead Interest may include depreciable tangible personal property or depreciable land improvements other than the surface parking lot, Taxpayer has not requested a ruling on such property. Accordingly, we will address only how to depreciate the portion of Taxpayer's basis in the Lead Interest that is allocable to the land, buildings (including the parking structure), and surface parking lot (a land improvement for depreciation purposes).

If the Lead Interest is used in a trade or business or held for the production of income by Taxpayer, the portion of Taxpayer's basis in the Lead Interest allocable to the land, buildings (including the parking structure), and surface parking lot are subject to the allowance for depreciation under section 167(a). In such a case, the portion of Taxpayer's basis in the Lead Interest allocable to the land is an intangible asset and, as a result, Taxpayer will depreciate such asset ratably over the term of the Lead Interest. Further, pursuant to sections 167(e)(4)(B) and 167(d), Taxpayer is treated as though it owned the buildings (including the parking structure) and surface parking lot for depreciation purposes and, therefore, Taxpayer will determine the depreciation for the portion of its basis in the Lead Interest allocable to such buildings (including the parking structure) and surface parking lot in accordance with section 168. However, no depreciation deduction is allowable under section 167, section 168, or any other provision of the Code to Taxpayer for the Lead Interest for any period during which the Remainder Interest is held (directly or indirectly) by a related person (within the meaning of section 267(b) or (e)).

## CONCLUSIONS

Based solely on the facts and representations submitted and the relevant law as set forth above, we conclude that:

1. If the Lead Interest is used in a trade or business or held for the production of income by Taxpayer, Taxpayer is entitled to depreciate the portion of Taxpayer's basis in the Lead Interest allocable to the land ratably over the term of the Lead Interest under section 167(a). However, no depreciation deduction is allowable under section 167 or any other provision of the Code to Taxpayer for the Lead Interest for any period during

which the Remainder Interest is held (directly or indirectly) by a related person (within the meaning of section 267(b) or (e)).

2. If the Lead Interest is used in a trade or business or held for the production of income by Taxpayer, Taxpayer is entitled to depreciate the portion of Taxpayer's basis in the Lead Interest allocable to the buildings (including the parking structure) and the surface parking lot in accordance with section 168. However, no depreciation deduction is allowable under section 167, section 168, or any other provision of the Code to Taxpayer for the Lead Interest for any period during which the Remainder Interest is held (directly or indirectly) by a related person (within the meaning of section 267(b) or (e)).

Except as specifically set forth above, we express no opinion concerning the federal income tax consequences of the facts described above under any other provisions of the Code. Specifically, no opinion is expressed or implied on: (i) whether each direct and indirect owner of Sellers is unrelated (within the meaning of section 267) to each direct and indirect owner of both Taxpayer and Remainderman, (ii) whether each direct and indirect owner of Taxpayer is unrelated (within the meaning of section 267) to each direct and indirect owner of Remainderman, (iii) whether Taxpayer is the owner of the Property during the term of the Lead Interest for Federal income tax purposes, (iv) whether the Lead Interest is used in a trade or business or held for the production of income by Taxpayer, or (v) whether the total purchase price of \$N6 is properly allocated by Taxpayer between the various assets comprising the Lead Interest.

In accordance with the power of attorney, we are sending a copy of this letter ruling to Taxpayer's authorized representative. We are also sending a copy of the letter ruling to the appropriate operating division director.

Sincerely,

Kathleen Reed

Kathleen Reed  
Chief, Branch 7  
Office of Associate Chief Counsel  
(Income Tax and Accounting)

Enclosures:

Copy of this letter  
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